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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964.

No. 342

THE HAYS CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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THE GUNTHORP-WARREN PRINTING COMPANY, CHICAGO

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

Petitioner prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in the above-entitled case on May 5, 1964.

OPINIONS BELOW.

The opinion of the Court of Appeals (Appendix A, *infra*, pp. .....) is reported in 331 F. 2d 422.

The opinion of the Tax Court (Appendix B, *infra*, pp. .....) is reported in 40 T. C. 436.

JURISDICTION.

The judgment of the Court of Appeals was entered on May 5, 1964. Rehearing was denied on May 26, 1964. Jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

QUESTION PRESENTED.

One corporation (transferee) acquires from the shareholders (transferors) of a second corporation all of the stock of the second corporation in exchange for the issuance of less than 8% of the stock of the first corporation. The first corporation and the shareholders of the second corporation are unrelated parties dealing at arm's length.

The question presented is as follows: Does the application of § 362(b) of the Internal Revenue Code of 1954 (which provides that the transferee's basis for the acquired stock shall be the same as it was in the hands of the transferors, rather than the actual cost basis of the acquired stock to the transferee) result in an unconstitutional tax under the Constitution of the United States (Article 1, § 2, clause 3; Article 1, § 9, clause 4; Amendment V) upon subsequent disposition of the acquired stock by the transferee?

CONSTITUTIONAL PROVISIONS AND STATUTE INVOLVED.

The provisions from the Constitution of the United States which are involved are: Article 1, § 2, clause 3; Article 1, § 9, clause 4; Amendment V and Amendment XVI.

The statutory provision involved is Internal Revenue Code of 1954, Section 362(b).

The pertinent parts of the provisions from the Constitution of the United States and statutes cited *supra* are set forth *infra* in Appendix C.

STATEMENT OF THE CASE.

The facts as stated by the Court of Appeals are not contested by petitioner and, accordingly, the following resume of the facts is quoted directly from the opinion of the Court of Appeals:

"Petitioner-taxpayer is an Indiana corporation engaged in the manufacture of precision instruments. Early in 1955, it began negotiations with four individuals (stockholders) who then owned all of the issued and outstanding common stock of Metrotype Corporation. Metrotype was an Illinois corporation engaged in the manufacture of data recordation metering devices, a business related in character to that conducted by Hays.

"These negotiations culminated in a written agreement dated May 14, 1955. Pursuant to the agreement plan, Hays issued 5,800 shares of its authorized but unissued corporate held voting common stock at an agreed value of $8.00 per share. It exchanged this stock for the 2,290 shares of Metrotype common stock owned by the stockholders at an agreed value of $20.26 per share. This exchange was at the ratio of 2.53+ shares of Hays voting common stock for one share of Metrotype common stock.

"As a result of this stock exchange, Hays became the corporate owner of all the outstanding stock of Metrotype. It is agreed that Hays and the stockholders were unrelated parties dealing at arm's length.

"On or about December 26, 1956, Metrotype was formally dissolved and liquidated under Illinois law. At the time of the dissolution and liquidation, the Metrotype stock was worthless. It is agreed that at the time of the exchange of stock the Metrotype stock in the hands of the stockholders had a cost basis to them of $22,966 and cost (market value) basis to Hays of $46,400.

"In its 1956 tax return, Hays claimed 'Losses on investment in and liquidation of subsidiary,' including $46,400 claimed to be its loss because of its Metrotype

stock having become worthless. This resulted in a net operating loss being carried forward to 1957.

"The Commissioner of Internal Revenue determined that the proper amount of loss deduction allowable because of the worthlessness of the Metrotype stock was $22,966, rather than $46,400 claimed by Hays on its 1956 return. The Tax Court affirmed the Commissioner's determination."

Jurisdiction was obtained in the Tax Court of the United States under the Internal Revenue Code of 1954, §§ 7442, 6211, 6212 and the Internal Revenue Code of 1939, § 272. After a statutory notice of deficiency dated August 11, 1959 was mailed to and received by the petitioner, a petition for a redetermination of the deficiency was timely filed with the Tax Court. The Court of Appeals for the Seventh Circuit affirmed the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT.

The decision of the Court of Appeals which interprets § 362(b) of the Internal Revenue Code of 1954 as being applicable to the factual situation involved in this case renders § 562(b) unconstitutional under Article 1, § 2, clause 3 and Article 1, § 9, clause 4 of the Constitution of the United States because it imposes a direct tax on petitioner's capital without apportionment. It also renders § 362(b) unconstitutional under Amendment V because it arbitrarily and unreasonably deprives petitioner of property without due process of law. Section 362(b) provides as follows:

"(b) Transfers to Corporation.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the

reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer."

As applied by the Court of Appeals to the transaction here involved, this section of the Internal Revenue Code requires petitioner to accept the basis ($22,966) of the former stockholders of Metrotype Corporation in order to determine profit or loss on subsequent disposition of the Metrotype Corporation stock acquired from the former stockholders of Metrotype Corporation, in spite of the fact that the actual cost of this stock to petitioner was $46,400 (being the agreed fair market value of petitioner's stock issued to the former stockholders of Metrotype Corporation).

Thus, even though there was an arm's length transaction between totally unrelated parties in which there was a *quid pro quo* exchange of stock, and after which the former shareholders of Metrotype Corporation did not have a controlling interest in petitioner (in fact, their shareholdings represented less than 8% of the issued and outstanding stock of petitioner after the transaction), petitioner nonetheless is required by the decision of the Court of Appeals to suffer the cost basis of the former shareholders of Metrotype Corporation as its substituted basis for the stock so acquired. Since the stock of Metrotype Corporation became worthless after it was acquired by petitioner, the decision of the Court of Appeals limits the deductible loss of petitioner for this stock to the substituted basis ($22,966) imposed by § 362(b) and thus denies to petitioner a deduction for the full value ($46,400) of the consideration it gave in exchange for the stock of Mettrotype Corporation, viz., the issuance of the shares of petitioner's stock having a fair market value of $46,400. Since the decision of the Court of Appeals limits petitioner's deductible loss to less than its actual economic loss, it thereby results in a tax on petitioner's capital which is prohibited by the aforementioned provisions of the United States Constitution because peti-

tioner is deprived from offsetting its actual economic loss against its income from other sources, resulting in a tax on income which does not exist and accordingly, and to such extent, a direct tax on capital without apportionment.

This is contrary to the decision of the Supreme Court of the United States in *Eisner* v. *Macomber*, 252 U. S. 189 (1920) wherein it was held that the Revenue Code of 1916 was unconstitutional since it authorized an unapportioned direct tax on capital, not a tax on "income" as authorized by the Sixteenth Amendment. Such a result also violates the due process clause of the Fifth Amendment which prohibits the taking of property without due process of law.

Section 113(a)(7) of the Internal Revenue Code of 1928 was the forerunner of § 362(b), and, prior to 1936, it was fundamentally different than § 362(b). Under the Internal Revenue Code of 1928, § 113(a)(7) provided as follows:

> "(a) Property acquired after February 28, 1913.—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—
>
> • • • • •
>
> "(7) Transfers to Corporation Where Control of Property Remains in Same Persons.—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, *and immediately after the transfer an interest or control in such property of 80 per centum or more remained in the same persons or any of them*, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless

acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer." (Emphasis supplied.)

However, as noted by the above italicized portion of § 113(a)(7), it does not correspond directly with § 362(b). The former provision required an eighty per cent control by the transferor before applying the basis of the transferor to the transferee. In other words, if the old provision were still in effect, it would not be imposed on the transaction here involved because the transferor (being the former shareholders of Metrotype Corporation) did not acquire eighty per cent control of petitioner as required by § 113(a)(7).

The Revenue Acts of 1932 and 1934 reduced the control test to fifty per cent, and under the Revenue Act of 1936, and all subsequent acts, no percentage of interest or control was required. Please see Merten's Law of Federal Income Taxation, § 21.115 (rev. ed., 1963).

Several decisions of the Supreme Court of the United States have held that the pre-1936 provision is constitutional where the transferor is in "control" of the transferee after the transaction is consummated. For example, please see *Consolidated Utilities Co.* v. *Comm.*, 84 F. 2d 548 (9th Cir., 1936). However, the Supreme Court of the United States has never had occasion to determine whether or not this provision is constitutional since 1936 when the "control" requirement was eliminated in determining whether or not the transferee was obligated to accept the basis of the transferor. It is petitioner's contention that the imposition of the transferor basis to petitioner under the facts here involved is unconstitutional because the parties here involved are totally unrelated and to impose the transferor's basis to petitioner results in a fictitious cost basis direct on capital as hereinabove described.

It is important to note that petitioner's contention does not result in a loss of tax revenue on any realized income to the taxing authorities of the United States, but that, on the contrary, the decision of the Court of Appeals results in double taxation on the same income. The following illustration clearly demonstrates this statement:

> Please assume that the stockholders of Metrotype Corporation had a collective cost basis of $100 and that they exchanged their stock in Metrotype Corporation to petitioner in exchange for stock of petitioner having a value and cost to petitioner of $500. Assume further that the stockholders of Metrotype Corporation on the following day sold their stock acquired from petitioner for the collective amount of $500. Assume further that petitioner on the day after the transaction sold its Metrotype Corporation stock for $500.

If the decision of the Court of Appeals is correct, the former stockholders of Metrotype Corporation would retain their original cost basis of $100 but petitioner would be required to accept a substituted basis of $100, a basis unrelated to petitioner's real economic cost of acquisition. Therefore, under the decision, both the transferor and the transferee—even though they are unrelated, independent parties and the transferor had no identity with or control over the transferee—are required to assume the same basis for their respective holdings, namely that of the transferor.

On ultimate sale of petitioner's stock by the former stockholders of Metrotype Corporation for $500, they realize a profit of $400 (their true economic gain). However, on a sale of Metrotype stock by petitioner for $500, petitioner realizes a taxable gain of $400, notwithstanding that petitioner has a true economic investment therein of $500 and accordingly has no actual profit. This results in taxing $800 of alleged income whereas, in reality, only $400 of actual economic profit exists. It inflicts on peti-

tioner a tax on $400 of profit which it did not in fact experience.

Where, as in this case, an economic loss is sustained, the deprivation of that loss to petitioner—on account of an arbitrary and fictitious basis which does not take into consideration petitioner's true economic investment—amounts to the taxing of capital, since there is no profit extant to tax.

It has been observed that ". . . with the single exception of the *Eisner* v. *Macomber* case, there has been no provision of income tax statutes adopted since the Sixteenth Amendment which has been held unconstitutional." Merten's Law of Federal Income Taxation, § 4.01 (rev. ed., 1963). Today, and with increasing jealousy, our Constitution has sheltered and protected the reasonable rights of the individual in the areas of criminal law, the elevation of human dignity through recognition of civil rights, and a multitude of other important constitutional prerogatives of the individual citizen. When one citizen is required, as a result of statute or lower court decision, to accept a basis that has no relationship to his economic investment, and therefore finds himself treated differently from his neighbor, the result is to perpetrate a basic wrong upon the individual citizen in relation to his obligations toward his government. It frequently has been stated by lower courts, and indeed it was stated in the opinion of the Circuit Court of Appeals in this case, that the allowance of deductions and losses is a matter of legislative grace. If there can be a statutory denial of deductions relating to the very existence of income at all, then a tax may be imposed under the Sixteenth Amendment without the existence of actual economic income. The Sixteenth Amendment permits the adoption of an income tax; it did not admit of a capital levy without apportionment. If there is no income to tax, then certainly there can be no

income tax. The tax, in the absence of income, must necessarily be a capital levy. Although the Sixteenth Amendment, by its express language, speaks only of permitting a tax on income, it has been universally conceived that the Sixteenth Amendment permits a tax on net income.

Under the circumstances of this case and the subsequent cases which will be bound by the precedent established by the Court of Appeals in this case, there is an important question of federal law which has not been, but should be, settled by this Court in order that the petitioner and other taxpayers in similar situations will not be forced to pay an unconstitutional tax on capital.

CONCLUSION.

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDICES.

Appendix A—Opinion of the Court of Appeals for the Seventh Circuit and Order on Motion for Rehearing

Appendix B—Opinion of the Tax Court of the United States

Appendix C—Pertinent Provisions from the Constitution of the United States and Statutes Involved

APPENDIX A.

IN THE UNITED STATES COURT OF APPEALS

For the Seventh Circuit.

No. 14378. September Term, 1963—April Session, 1964

THE HAYS CORPORATION, *Petitioner*,
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition for Review of the Decision of the Tax Court of the United States.

May 5, 1964

Before HASTINGS, *Chief Judge*, and DUFFY and MAJOR, *Circuit Judges*.

HASTINGS, *Chief Judge*. We have for review a decision of the Tax Court of the United States concerning deficiencies in federal income taxes of petitioner, The Hays Corporation, for the year 1957. Tax Court Docket No. 87979. The opinion of the Tax Court, by Judge Forrester, was filed May 28, 1963. Decision was entered pursuant thereto July 8, 1963. The decision and supporting opinion are reported. *Hays Corporation*, 40 T.C. 436.

Most of the facts were stipulated. We are concerned only with questions of law.

Petitioner-taxpayer is an Indiana corporation engaged in the manufacture of precision instruments. Early in 1955, it began negotiations with four individuals (stock-

holders) who then owned all of the issued and outstanding common stock of Metrotype Corporation. Metrotype was an Illinois corporation engaged in the manufacture of data recordation metering devices, a business related in character to that conducted by Hays.

These negotiations culminated in a written agreement dated May 14, 1955. Pursuant to the agreement plan, Hays issued 5,800 shares of its authorized but unissued corporate held voting common stock at an agreed value of $8.00 per share. It exchanged this stock for the 2,290 shares of Metrotype common stock owned by the stockholders at an agreed value of $20.26 per share. This exchange was at the ratio of 2.53¼ shares of Hays voting common stock for one share of Metrotype common stock.

As a result of this stock exchange, Hays became the corporate owner of all the outstanding stock of Metrotype. It is agreed that Hays and the stockholders were unrelated parties dealing at arm's length.

On or about December 26, 1956, Metrotype was formally dissolved and liquidated under Illinois law. At the time of the dissolution and liquidation, the Metrotype stock was worthless. It is agreed that at the time of the exchange of stock the Metrotype stock in the hands of the stockholders had a cost basis to them of $22,966 and cost (market value) basis to Hays of $46,400.

In its 1956 tax return, Hays claimed "Losses on investment in and liquidation of subsidiary," including $46,400 claimed to be its loss because of its Metrotype stock having become worthless. This resulted in a net operating loss being carried forward to 1957.

The Commissioner of Internal Revenue determined that the proper amount of loss deduction allowable because of the worthlessness of the Metrotype stock was $22,966, rather than $46,400 claimed by Hays on its 1956 return. The Tax Court affirmed the Commissioner's determination.

The propriety of this determination and ruling is the only question in issue before us.

The Commissioner contends and the Tax Court held the stock exchange in question effected a "B" reorganization within the definition of Section 368(a)(1)(B) of the Internal Revenue Code of 1954; that no gain was recognized on the transaction under Section 354(a)(1) of the 1954 Code; and that taxpayer's basis in the Metrotype stock was the aggregate of its basis in the hands of its transferors, by virtue of Section 362(b) of the 1954 Code.

Taxpayer contends that its basis in the Metrotype stock was not limited by Section 362(b), but was the fair market value of the stock it issued in exchange therefor. It urges there was no plan of reorganization to which both corporations were a party under Section 354(a)(1) and hence the nonrecognition provisions of the Code are not applicable and the exchange was taxable. It argues that if Section 362(b) is applicable and requires it to accept the basis of an unrelated transferor, it is unconstitutional as a tax on capital under Art. I, Secs. 2 and 9 of the federal Constitution and as violative of the Due Process Clause of the Fifth Amendment.

We affirm the decision of the Tax Court and hold that the written agreement prescribing the terms of the stock exchange was a "plan of reorganization" as set out in Section 354(a)(1); that Metrotype was a "party to a reorganization" as defined in Section 368(b)(2), since this was "the case of a reorganization resulting from the acquisition by one corporation *of* stock or properties of another." (Emphasis added.) This clearly results in a "B" reorganization within Section 368(a)(1)(B).

We are concerned here with the *amount* of taxpayer's claim of loss deduction. The deduction itself is undisputed; only the amount is in question. That amount is determined by the provision in Section 362(b) that "the

basis shall be the same as it would be in the hands of the transferor." Since Congress has the power to determine whether and to what extent deductions of losses shall be allowed in computing income taxes, as a matter of legislative grace, *New Colonial Co.* v. *Helvering*, 292 U. S. 435 (1934), we agree with the Tax Court that an allowance "of such deduction limited by the basis of a transferor is not unconstitutional." 40 T.C. at 443.

The opinion of the Tax Court sets out the plan of reorganization, the text of applicable sections of the Code and pertinent regulations and considers cited decisions relevant thereto. Since we are in agreement with the reasoning and decision of that court, we see no need to rewrite its opinion and reference is now made thereto. We adopt it as part of this opinion.

For the reasons stated in 40 T.C. 436, the decision of the Tax Court under review is affirmed.

AFFIRMED.

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Chicago, Illinois, 60610

Tuesday, May 26, 1964

Before

Hon. John S. Hastings, Chief Judge,
Hon. F. Ryan Duffy, Circuit Judge,
Hon. J. Earl Major, Circuit Judge.

The Hays Corporation, *Petitioner,*	Petition for review of a decision of the Tax Court of the United States.
No. 14378 *vs.*	
Commissioner of Internal Revenue, *Respondent.*	

IT IS ORDERED by the Court that the petition of the petitioner for a rehearing of this cause be, and the same is hereby, DENIED.

APPENDIX B.

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40 T. C. No. 49

TAX COURT OF THE UNITED STATES

The Hays Corporation, Petitioner, v. Commissioner of Internal Revenue, Respondent.

Docket No. 87979. Filed May 28, 1963.

All the stock of M corporation was owned by individuals A, B, C, and D. In 1955, petitioner issued some of its voting stock and, pursuant to written contract with A, B, C, and D, exchanged it for all of their stock of M.

Held: The transaction constituted a reorganization (sec. 368(a)(1)(B), I. R. C. 1954) to which M was a party (sec. 368 (b)(2), I. R. C. 1954). No gain was recognized by A, B, C, and D on the transaction (sec. 354(a)(1), I. R. C. 1954), and petitioner's basis in the M stock was the aggregate of the bases of A, B, C, and D (sec. 362(b), I. R. C. 1954).

James F. Thornburg, and *Edward J. Gray*, for the petitioner.

George H. Becker, for the respondent.

OPINION.

FORRESTER, *Judge*: Respondent has determined a deficiency in income tax of petitioner for the taxable year 1957 in the amount of $12,185.68. Petitioner has agreed to certain adjustments and the issue remaining is whether petitioner's basis in certain stock was its cost to petitioner or its basis in the hands of its former holders. Wholly depend-

ent on the resolution of this issue is the determination of the amount of a net operating less carryover to the year before us.

Most of the facts have been stipulated and are so found.

Petitioner is an Indiana corporation with principal offices located at Michigan City, Indiana. It is engaged in the manufacture of precision instruments. It filed its Federal income tax returns for the calendar years 1956 and 1957 with the district director of internal revenue at Indianapolis, Indiana.

In the early part of 1955, petitioner began negotiations with George E. Foster, Lucille A. Foster, Edgar M. Corson, Jr., and Effie G. Armstrong, the then owners of all of the issued and outstanding common stock of Metrotype Corporation, hereinafter referred to as Metrotype, an Illinois corporation with principal offices located in Chicago, Illinois.

Metrotype was engaged in the manufacture of data recordation metering devices, a buisness complementary to and allied with the business conducted by petitioner.

These negotiations culminated in an agreement dated May 14, 1955, which provided in part:

CONTRACT FOR EXCHANGE OF CORPORATE STOCK.

THIS AGREEMENT is made and entered into in multiple counterparts, each of which shall be deemed an original, at Michigan City, Indiana, on the 14th day of May, 1955, by and between The Hays Corporation, an Indiana corporation with principal offices at Michigan City, Indiana, hereinafter referred to as "Hays," and George E. Foster, Lucille A. Foster, Edgar M. Corson, Jr. and Effie G. Armstrong, all of Chicago, Illinois, hereinafter referred to as "Stockholders."

WITNESSETH:

In that, at the effective date of this contract, all of the Stockholders presently are owners of one or more shares of common capital stock issued by Hays, and also are owners of all of the issued and outstanding capital stock of Metrotype Corporation and are desirous of exchanging shares of the common capital stock of Metrotype Corporation, an Illinois corporation with principal offices at Chicago, Illinois (and hereinafter referred to as "Metrotype") now owned by them for additional shares of common capital stock of the Hays Corporation upon the basis hereinafter set forth; and

In that Hays presently has treasury stock, together with authorized but unissued common capital stock, sufficient to provide the requisite shares of common stock to be issued by The Hays Corporation upon the basis of exchange hereinafter set forth; and

In that Metrotype is engaged in a business complementary to and allied with the business conducted by Hays, and it is considered by all parties hereto that the acquisition of all Metrotype stock by Hays will result in economies and enhanced business potential for both corporations; and

In that the parties have determined by negotiation and investigation that the value of Hays common stock is in the sum of Eight Dollars ($8.00) per share and that the value of each share of Metrotype common stock is in the sum of Twenty and 26/100 Dollars ($20.26) and, therefore, that Five thousand eight hundred (5,800) shares of common capital stock of The Hays Corporation should be exchanged for the Two thousand two hundred ninety (2,290) shares of common stock issued by Metrotype, being a ratio of 2.53⅛ shares of The Hays Corporation stock for each one share of Metrotype Corporation common stock; and in that a plan of statutory reorganization within the meaning of the Internal Revenue Code of 1954 has been promulgated and adopted by Hays and is agreeable to Stockholders whereby such exchange should be ac-

complished under and pursuant to Sections 354(a)(1) and 368(a)(1)(B) of the Internal Revenue Code of 1954;

• • • • •

SECTION C: HAYS AGREES:

1. Upon the closing date, to issue and deliver to Stockholders the number of shares of Hays common capital stock hereinafter immediately set opposite the name of each stockholder:

George E. Foster	3351 shares
Lucille A. Foster	557 shares
Edgar M. Corson, Jr.	1740 shares
Effie G. Armstrong	152 shares

in exchange for the shares of common capital stock of Metrotype to be delivered to Hays in accord with the undertaking of Stockholders made at Paragraph 1 of Section D hereof. All documentary stamps requisite to the transfer of Hays shares shall be procured and properly affixed at the expense of Hays.

• • • • •

SECTION D: STOCKHOLDERS AGREE:

1. Upon the closing date, to issue and deliver to Hays all issued and outstanding shares of Metrotype, being two thousand two hundred ninety (2,290) shares in total, duly endorsed with bank guaranteed signature in form sufficient to invest Hays with title thereto in exchange for common capital stock of Hays delivered to Stockholders in accord with the undertaking of Hays set forth at Paragraph 1 of Section C. All documentary stamp taxes in connection with the issuance or delivery of stock under this Paragraph 1 shall be at the expense of Stockholders.

• • • • •

3. Upon or at any time after the closing date, Stockholders, at the written request of Hays, shall tender the written resignations to Hays of all of the

present officers and directors of Metrotype. The effective date of such resignations shall be as requested by Hays.

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the date and at the place hereinabove first mentioned.

THE HAYS CORPORATION,
By /s/ PHIL SPRAGUE, JR.,
Its Executive Vice President,

Attest:
/s/ OTTO ZIEGLER,
Its Secretary-Treas.

(Seal) /s/ EDGAR M. CORSON, JR.,
(Seal) /s/ GEORGE E. FOSTER,
(Seal) /s/ EFFIE G. ARMSTRONG,
(Seal) /s/ LUCILLE A. FOSTER.

Pursuant to this agreement petitioner transferred 5,800 shares of its previously authorized, but unissued shares of voting common stock to the stockholders of Metrotype and in turn the stockholders of Metrotype transferred 2,290 shares of stock in Metrotpye to petitioner. The aforementioned 2,290 shares of Metrotype stock was all of the issued and outstanding stock of Metrotype.

The petitioner and the stockholders of Metrotype were unrelated independent parties dealing at arm's length.

On May 14, 1955, George E. Foster, Edgar M. Corson, Jr., and Lucille A. Foster were president, vice president, and secretary-treasurer, respectively, of Metrotype.

On or about December 26, 1956, Metrotype was formally dissolved and liquidated under the laws of the State of Illinois. At the time of the dissolution and liquidation, the Metrotype stock was worthless.

On its income tax return for the year 1956, petitioner deducted $294,788.23 as "Losses on investment in and

liquidation of subsidiary." This sum consisted of certain amounts claimed as bad debt losses, plus $46,400 claimed to be petitioner's loss on the worthless Metrotype stock. Petitioner's total deductions exceeded its total income returned for the year 1956, and thus no income tax was reported as due for that year.

On its income tax return for the year 1957, petitioner deducted $26,852.33 as a net operating loss carried over from 1956. This amount represented the excess of the net operating loss shown on petitioner's 1956 return over the amounts thereof carried back to the 1954 and 1955 taxable years.

Respondent determined that the amount of net operating loss petitioner was entitled to deduct in 1957 as a carry-over from 1956 was only $990.58. This determination was based in large part upon a determination that petitioner's adjusted basis in the Metrotype stock was $22,966, rather than the $46,400 claimed by petitioner on its 1956 return in connection with the deduction taken in that year in respect of losses upon the liquidation of Metrotype. The propriety of the latter determination is the only question put in issue herein by petitioner.

Respondent contends that the basis of the Metrotype stock in the hands of that company's four former shareholders was $22,966; that the exchange made by petitioner for the Metrotype stock, pursuant to the agreement of May 14, 1955, was a reorganization within the meaning of section 368(a)(1)(B)[2] of the Internal Revenue Code of

1. This has not been disputed by petitioner.

2. SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) Reorganization.—

(1) In General.—For purposes of parts I and II and this part, the term "reorganization" means—

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of

1954;[3] that the reorganization was nontaxable under section 354(a)(1);[4] and that petitioner's basis in the Metrotype stock was consequently $22,966, its basis in the hands of its transferors, by virtue of section 362(b).[5]

Petitioner contends that its basis in the Metrotype stock was not limited by section 362(b), but was rather the fair market value of the stock issued by petitioner in exchange therefor. Petitioner argues that the exchange did not come within the provisions of section 354(a)(1) and hence was taxable.[6]

another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

3. Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954.

4. SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) General Rule.—

(1) In General.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

5. SEC. 362. BASIS TO CORPORATIONS.

(b) Transfers to Corporations.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

6. Petitioner is not sure whether, if the exchange did not come within sec. 354(a)(1), its basis in Metrotype should be determined with reference to its cost (the fair market value of the stock in petitioner exchanged therefor) or with reference to the basis of the former Metrotype shareholders plus the gain that would be recognized by them on the exchange (pursuant to the last clause

Petitioner's argument hinges on its contention that Metrotype Corporation was not "a party to the reorganization" as that term is used in section 354(a)(1), and that the exchange therefore did not meet the requirements of that section for nonrecognition of gain or loss.[7] It contends that to be a party to a reorganization one must be a "participant in" the transactions constituting the reorganization, and that Metrotype was not such a party. It extends this argument further to say that in order for nonrecognition to apply to a "(B)" reorganization, the stock received by the acquiring corporation must be acquired *from* the acquired *corporation*.

Petitioner relies heavily on *Mahlon D. Thatcher*, 46 B.T.A. 869 (1942), reversed on other grounds 137 F. 2d 128 (C.A. 10, 1943), acq. 1942-2 C.B. 18. But the *Thatcher* case on its facts is certainly not this case. There the import of the opinion was that there was no plan of reorganization. Here there plainly was.

Respondent contends that as a matter of law Metrotype was "a party to the reorganization" by virtue of section 368(b)(2). We agree with respondent.

of the first sentence of sec. 362 (b). This confusion is due to uncertainty as to whether a reorganization exchange of stock for stock *not* coming within the terms of sec. 354 (a) (1) as a reorganization to which the reorganization provisions otherwise apply, within the meaning of sec. 362 (b). Even if we were not to adopt respondent's position herein, which we do, we would not have occasion in this case to resolve this question, for the basis arrived at under either method of computation would be identical and would turn on a determination of the fair market value of the stock in petitioner exchanged for the Metrotype stock. Because of our determination herein, however, we need not make a finding as to that fair market value.

7. Petitioner does not deny that, if Metrotype was "a party to a reorganization," that reorganization was a nontaxable "B" reorganization and resulted in petitioner's basis in the Metrotype stock being the aggregate of the bases of the four former shareholders of Metrotype, by virtue of sec. 362 (b).

Section 368(b) provides as follows:

> (b) Party To a Reorganization.—For purposes of this part, the term "a party to a reorganization" includes—
>
> (1) a corporation resulting from a reorganization, and
>
> (2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another. * * *

The term "party to a reorganization" was neither used nor defined statutorily prior to the Revenue Act of 1924. That statute added a new section 203(h)(2) which read as follows:

> Sec. 203(h) As used in this section and sections 201 and 204—
>
> * * * * *
>
> (2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

The Congressional Committees' explanation for this section said: (H. Rept. No. 179, to accompany H. R. 6715 (Pub. L. 176), 68th Cong., 1st Sess., p. 53 (1924); S. Rept. No. 398, to accompany H. R. 6715 (Pub. L. 176), 68th Cong., 1st Sess., p. 17 (1924)):

> (2) There is no provision of the existing law which corresponds to subdivision (h) (2) of the bill. This definition is inserted to remove any doubt as to whether a corporation, all of the stock of which is acquired in connection with the reorganization, is a party to the reorganization.

---

8. 43 Stat. 253.

We conclude that the Congressional intent (now in section 368(b)(2)) requires that Metrotype be deemed a party to the reorganization.[9]

The regulations promulgated pursuant to this statutory provision have always treated the acquired corporation as a party to the reorganization when the acquiring corporation gets a controlling stock interest in such acquired corporation from a third corporation which happens to own such stock. See section 29.112(g)-2, Regs. 111; section 39.112(g)-2(f), Regs. 118; and section 1.368-2(f), Income Tax Regs. The current regulation provides, in part, as follows:

> § 1.368-2 Definition of terms.
>
> * * * * *
>
> (f) The term "a party to a reorganization" includes a corporation resulting from a reorganization, and both corporations, in a transaction qualifying as a reorganization where one corporation acquires stock or properties of another corporation. * * * Both Corporation O and Corporation P, but not Corporation S, are parties to the reorganization if Corporation O acquires stock of Corporation P from Corporation S in exchange solely for a part of the voting stock of Corporation O, if (1) the stock of Corporation P does not constitute substantially all of the assets of Corporation S, (2) Corporation S is not in control of Corporation O immediately after the acquisition, and (3) Corporation O is in control of Corporation P immediately after the acquisition.

We can see no valid reason for a different result if Corporation S were an individual or a group of individuals. The regulations promulgated under the Internal Revenue

9. It is noted that a new corporation resulting from a reorganization is a party thereto. Sec. 368(b)(1). This is entirely inconsistent with petitioner's urged requirement of active participation in the plan of reorganization.

Code of 1939 strongly suggest this conclusion.[10] Thus, for decades the regulations under this statute have treated the acquired corporation as a party to a reorganization whenever its stock is acquired by another corporation (if the transaction otherwise satisfies section 368(a)(1)), regardless of the identity of the transferor of such stock. It must be noted that Congress has consistently re-enacted the predecessors of section 368(b)(2), fully cognizant of the regulations interpreting them, and it must be assumed that Congress has approved such interpretation. *Cammarano v. United States*, 358 U. S. 498, 510 (1959); *Mass. Mutual Life Ins. Co. v. United States*, 288 U. S. 269, 273 (1933).

In light of the legislative history and a literal reading of section 368(b)(2), we believe our holding that Metrotype was a party to the reorganization is consonant with what Congress intended. Petitioner's interpretation, that for a "(B)" reorganization to occur the acquired corporation must participate in the transactions, and that the stock received by the acquiring corporation must be received *from* the acquired corporation, would render section 368(b)(2) ineffectual. The language of this section, like other sections of the Act, is "acquisition by one corporation of stock or properties *of* another." (Emphasis supplied.) Congress could easily have said *from* another if that had been the desired intent.

The Congressional purpose was to remove any doubt that the acquired corporation is to be considered a party to the reorganization as a matter of Federal income tax law, and

10. They provide:

§ 39.112(g)-2 [Regs. 118] Definition of terms.

* * *

(f) * * *. Only Corporations H and J are parties to the reorganization if it consists of the acquisition by Corporation H in exchange solely for all or a part of its voting stock of at least 80 percent of the voting stock and at least 80 percent of the total number of shares of all other classes of stock of Corporation J, *even though such acquisition by Corporation H is from Corporation K*. [Emphasis supplied.]

obviously there would be no such doubt in those cases petitioner argues are the only ones encompassed by the statute. We perceive no reason to suppose that Congress intended only those "(B)" reorganizations in which some stock is acquired from the acquired corporation to qualify for nonrecognition of gain or loss.

We hold, therefore, that the 1955 transaction was a reorganization on which the four former shareholders of Metrotype recognized no gain, pursuant to section 354(a)(1). Consequently, we hold further that petitioner's basis in the Metrotype stock was $22,966, that of the latter's four former shareholders, by virtue of section 362(b), as determined by respondent.

Petitioner argues that such a result would be inequitable as to it. Such an argument cannot be considered by us, however, as we do not have the jurisdiction of a court of equity. *Commissioner* v. *Gooch Co.*, 320 U. S. 418 (1943); *Lorain Avenue Clinic*, 31 T. C. 141 (1958). "The Internal Revenue Code, not general equitable principles, is the mainspring of [our] jurisdiction." *Commissioner* v. *Gooch Co.*, *supra*, at 422. The proper place for a consideration of petitioner's complaint is the halls of Congress, not here.

Petitioner pleads and argues further that, in so far as section 362(b) requires a transferee to accept the basis of an unrelated transferor, it is unconstitutional as a tax on capital[11] and as violative of the due process clause.[12] The mere carryover of basis is per se neither a tax nor a taking of property. It is unquestioned that Congress has the power to deny petitioner's loss deduction in toto, if it so desires. *New Colonial Co.* v. *Helvering*, 292 U. S. 435. Allowance of such deduction limited by the basis of a transferor is not unconstitutional.

Because of concessions,

Decision will be entered under Rule 50.

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11. U. S. Const., Art. I, secs. 2 and 9.
12. U. S. Const., Amend. V.

APPENDIX C.

U. S. CONSTITUTIONAL PROVISIONS INVOLVED.

Article 1, Section 2, Clause 3. *Apportionment of Representatives and Taxes.*

"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons. The actual Enumeration shall be made within three Years after the first Meeting of the Congress of the United States, and within every subsequent Term of ten Years, in such Manner as they shall by Law direct. The Number of Representatives shall not exceed one for every thirty Thousand, but each State shall have at Least one Representative; and until such enumeration shall be made, the State of New Hampshire shall be entitled to chuse three, Massachusetts eight, Rhode-Island and Providence Plantations one, Connecticut five, New-York six, New Jersey four, Pennsylvania eight, Delaware one, Maryland six, Virginia ten, North Carolina five, South Carolina five, and Georgia three."

Article 1, Section 9, clause 4. *Capitation and other direct taxes.*

"No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

Amendment V.—*Capital Crimes; Double Jeopardy; Self-Incrimination; Due Process; Just Compensation for Property.*

"No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

Amendment XVI.—*Income Tax.*

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

STATUTES INVOLVED.

INTERNAL REVENUE CODE OF 1954, SECTION 362(b).

"Transfers to corporations.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer."

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 342

THE HAYS' CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In May 1955, in a transaction qualifying as a tax-free "reorganization" under § 368(a)(1)(B) of the Internal Revenue Code of 1954, petitioner acquired all of the stock of the Metrotype Corporation in exchange solely for 5800 newly-issued shares of its own voting stock. The Metrotype stock had a basis in the hands of the transferors of $22,966. Because the transaction was a reorganization, the transferors recognized no gain upon their receipt of petitioner's stock (§ 354(a)) and petitioner took over the Metro-

type stock with the same basis it had in the hands of the transferors (§ 362(b)).

Metrotype became insolvent and was liquidated in 1956, entitling petitioner to deduct as a loss in that year the full amount of its basis in the stock (§ 165 (g)(3)). Under § 362(b) of the Code, as noted above, its basis was $22,966, its transferors' basis. Petitioner contends, however, that the statute is unconstitutional, that it was entitled to recover its "cost" for the stock, and that its "cost" was the fair market value of its own stock issued in exchange for it (allegedly, $46,400). The Tax Court and the court of appeals both upheld a deficiency determined in accordance with the statute.[1]

The basic concept that has guided Congress' treatment of "reorganizations" is that, in such transactions, the transferors retain a continuing interest in the same underlying assets and it is only the form of their ownership that is changed. Because of that continuity of interest, it is deemed appropriate to treat the transaction as neither a "sale" by the transferor (requiring a reckoning up of gain or loss) nor a "purchase" by the transferee (providing a new basis on which to account for future dispositions) and to postpone the tax accounting for any gains or losses until a more definitive severance takes place. Such a specification of the kinds of transactions that will be treated as taxable events is plainly within the

[1] The proceedings actually involve 1957, to which petitioner sought to carry over a part of the loss, but the sole issue is the computation of the loss incurred in 1956.

power of Congress to define "income" for purposes of the Sixteenth Amendment. The petition presents no substantial question and should be denied.

Respectfully submitted.

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SEPTEMBER 1964.

U.S. GOVERNMENT PRINTING OFFICE 1964

Office Supreme Court, U.S.
FILED
SEP 14 1964
JOHN F. DAVIS, CLERK

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REPLY BRIEF OF THE PETITIONER.

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REPLY BRIEF OF THE PETITIONER

It respectfully is submitted that, in his Memorandum in Opposition, Respondent is in error with respect to two fundamental points. First, Respondent assumes that there is a "continuity of interest" between the transferors (the shareholders of Metrotype Corporation) and Petitioner. This assumption is incorrect, because the transferors owned four-fifths of the capital stock of Metrotype Corporation prior to the transaction here involved, and subsequently became the owners of less than 8% of the capital stock of Petitioner corporation after the transaction. Thus, as originally contended by Petitioner, there was no "continuity of interest" on the part of the transferors, because more than 92% of the stockholders had an interest completely different from and alien to that of the transferors.

Second, Respondent assumes that because Congress has the power to postpone tax accounting—i.e., thus determine "when" a tax should be imposed, it also has the power to exact from a taxpayer, as a condition thereof, a "new basis on which to account for future dispositions," even to the extent that such exaction or condition results in an unconstitutional tax on capital. This is particularly true, in the instant case, when there would have been no tax to Petitioner at the time it issued its stock, since there is no income experienced on an original issuance of stock. § 1032(a) of the Internal Revenue Code of 1954, as amended, provides:

> "Nonrecognition of Gain or Loss.—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation."

In his Memorandum in Opposition, Respondent states that:

> "...Such a specification of the kinds of transactions that will be treated as taxable events is plainly within the power of Congress to define 'income' for purposes of the Sixteenth Amendment."

The issue here is not a determination of "when" income or loss is experienced, *i.e.*, "taxable event," but whether or not income or loss is "actually" experienced. The petition, therefore, presents a substantial question of undecided constitutional law and should be granted.

Respectfully submitted,

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